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LATE TESTIMONY

## HOUSE COMMITTEE ON LABOR & PUBLIC EMPLOYMENT

### TESTIMONY REGARDING HB 2459 RELATING TO PENSION INCOME

**TESTIFIER: KURT KAWAFUCHI, DIRECTOR OF TAXATION (OR DESIGNEE)**

**DATE: FEBRUARY 8, 2008**

**TIME: 8:30AM**

**ROOM: 309**

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This legislation amends Hawaii's income tax law to exempt the first \$100,000 of ERS pension income and other private sector pension income from taxable income.

The Department of Taxation (Department) **has concerns with this measure because it results in a tax increase for Hawaii workers that rely on pension income and strongly recommends that the Committee consider passing HB 3194.**

#### **I. THIS LEGISLATION IS A TAX INCREASE FOR PUBLIC WORKERS AND FOR THOSE WITH TRADITIONAL PENSIONS.**

This legislation results in a tax increase for public workers that have worked diligently relying upon a lower salary in exchange for tax-free pension income when they retire from government work. Effectively, this bill only exempts the first \$100,000 of Employee Retirement System (ERS) income from state tax. All other ERS benefits will be considered taxable after this amount. Because government workers have been enticed to remain on-the-job and not seek highly competitive private sector work on the presumption that any retirement benefits will be tax free, this legislation is inappropriate.

The same argument holds for persons that receive "traditional pension" income. There are few employers that offer pension income, as defined for Hawaii tax purposes. Pension income is any income provided by an employer is considered tax-free. Employees fortunate enough to have a fixed pension stream of income have likewise also accepted a lower salary over their lifetime in exchange for a tax-free annuity. This legislation also caps this tax exemption that these private sector employees and employers have relied upon.

#### **II. THIS BILL DOES NOT HELP ANY PRIVATE SECTOR EMPLOYEES.**

Assuming the intent of this legislation was to bring parity to the taxation of government retirees and private sector retirees, this intent has not been accomplished.

The bill amends Hawaii income tax law to exempt the first \$100,000 of "any" compensation for past services in the form of a pension. Because this bill does not amend the definition of pension or create a new exemption for income other than pension income, the current definition of pension will control. Pension is defined, briefly, as any income provided by an employer. Any employee-provided contributions to tax deferred savings accounts such as a 401(k) or IRA will remain taxable upon distribution.

The Department further opposes this bill because the bill does not provide any tax relief for the persons that have no pension income. The dialogue that should be occurring on this bill should be to bring parity to the taxation of retirement income—not increasing taxation on retirement income. Because this bill does not help private sector employees with no pension income from receiving a similar tax benefit as government retirees and those with pensions, the Department opposes this bill.

### **III. CONSIDER HB 3194 THAT MAINTAINS THE EXEMPTION OF RETIREMENT INCOME FOR PENSION HOLDERS AND PROVIDES RELIEF TO THOSE WITHOUT TRADITIONAL PENSIONS.**

The Department strongly urges the Committee to consider the Administration measure on this topic because it accurately maintains the status quo for taxation of pensions. However, it also allows for private employees that have to save for their own retirement to obtain a tax benefit.

Currently, there is a disparity in Hawaii's income tax law relating to the taxation of retirement income. The retirement income of all ERS participants is entirely exempt from income taxation. Also, all employer contribution "pension" income is exempt from income taxation.

The disparity in retirement income taxation arises due to the modern shift from true pension income retirement plans to self-managed retirement plans, such as 401(k) plans and Individual Retirement Accounts. The income distributions from these latter plans that are from employee savings are fully taxable for Hawaii income tax purposes. Because of the shift from employer pensions to privatized retirement accounts in the private sector, there are fewer retired individuals that qualify for Hawaii income tax exemption for retirement income than in years past. The intent of Hawaii's retirement income tax exclusion was to minimize the financial burden on retired persons, who are typically living on fixed-income and in a more vulnerable financial position.

HB 3194 amends Hawaii tax law by excluding the first \$25,000 of taxable retirement income earned for persons filing as single or married filing separately; \$42,500 for persons filing as head of household or surviving spouse; and \$50,000 for persons filing a joint return, provided that the taxpayer (or at least one spouse) is 65 years old or has attained age 65 by the close of the taxable year. The maximum exemption amounts phase out based upon a sliding scale, reducing the

exemption amount in excess of the exemption amount. The sliding scale is to phase out the maximum amounts in intervals of not less than \$100, as determined by the department of taxation.

Persons that are participants of the Employee Retirement System or whom have employer-funded pensions will be required to reduce the general exclusion amount by the amount of otherwise excluded retirement income. However, an employee with strictly ERS or pension income will not see a reduction in pension tax benefits—all pension money received over their \$25,000 exemption will still be exempt. This allows for parity amongst all retirees in Hawaii because it provides all employees at least \$25,000 in tax free income—whether public or private employee.

#### **IV. TECHNICAL CONCERN**

The Department points out that this legislation does not specify whether the \$100,000 exemption is a per-year exemption; or whether the exemption is in the aggregate. The Department presumes the former; however the bill should be amended to clarify the exemption is \$100,000 per year.

#### **V. REVENUE ESTIMATE**

This legislation will result in an estimated revenue gain of \$1 million per year.